

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER 04-0352P

**TAX ADMINISTRATION—NEGLIGENCE PENALTIES FOR
THE PERIOD COVERING CALENDAR YEARS 1999-2002**

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ISSUE

I. Tax Administration—Negligence Penalties

Authority: IC §§ 6-8.1-5-1(b), -10-2.1 (1998) (2004); 45 IAC §§ 15-5-3(b)(8), -11-2 (1996) (2001)

The taxpayer protests the parts of the proposed assessments that assess negligence penalties.

STATEMENT OF FACTS

The taxpayer is a corporation engaged in the business of distributing automotive paints, coatings and paint-related accessories, mainly to the automotive collision repair industry. Including its headquarters, it maintained four business locations in Indiana during calendar years 1999-2002 (hereinafter “the audit period”).

The Department conducted an audit of the taxpayer for gross retail (i.e., sales) and use tax for the audit period. The Department ultimately adjusted both the sales and use tax liabilities of the taxpayer for the audit period. The Audit Division issued Notices of Proposed Assessment of both sales and use tax. The taxpayer paid the respective base taxes and interest, but protested the respective proposed negligence penalties. The Department will provide additional facts as needed.

DISCUSSION

The taxpayer argues that the Department erred by imposing negligence penalty assessments. In its initial protest letter, which the taxpayer submitted itself, it contended that the deficiencies were attributable to the disruption caused by relocating to Indiana before the audit period. However, at the protest hearing, in response to a question from the hearing officer, the taxpayer’s

representative indicated that the taxpayer was no longer pursuing this argument, which the Department accordingly deems to be waived for purposes of this protest.

The taxpayer now submits the Department allegedly erred in deciding to propose negligence penalties based on a comparison of use tax actually paid to the tax the Department determined the taxpayer should have paid, i.e. to the tax paid with its returns plus the audited deficiencies. It contends the Department instead should view the use tax assessments, which were each in the low five-figure range, as a percentage of the respective total purchases for the corresponding period. The taxpayer represents (but has not documented) that these purchases are in the low nine-figure range annually. The taxpayer submits that, if so viewed, the respective error percentages for each assessed period are so low as to prove that its use tax self-accrual system is highly accurate and that the taxpayer therefore was not negligent. The taxpayer also argues that it would not be exercising “ordinary business care and prudence” as 45 § IAC 15-11-2(c) (1996) (2001) (which defines “negligence”) uses that phrase, if it were to implement a use tax self-assessment system that was one hundred percent accurate. In the taxpayer’s view, ordinary business care and prudence would require it to do a cost-benefit analysis of any such system, which it claims would indicate that the (unspecified) cost would be prohibitive and far outweigh any additional compliance benefit. Lastly, the taxpayer submits that even if the Department applies the audit error percentage it found for the assessed period with the highest percentage, the use tax self-accrual system is at its worst approximately 95% accurate. The taxpayer argues that this percentage is accurate enough to make the taxpayer’s use of its system not negligent.

Before addressing the taxpayer’s new arguments, to make clear what they do not cover and the resulting narrow scope of this Letter of Findings, the Department must first lay a factual foundation by describing the use tax audit methodologies employed, two of which the taxpayer later ratified. The field auditor’s focus was on the taxable categories of capital assets, leases and expensed purchases. She conducted census audits of the taxpayer’s capital asset purchases and of one computer hardware lease because it began in mid-2000, unlike the taxpayer’s other tangible personal property leases. The auditor sampled these remaining leases and the expensed purchases. She used the total lease activity for the lease sample period, excluding the computer hardware lease, as her total sampled leases.

In contrast, to generate the expensed purchases sample, the Audit Division used computer software to select random accounts, and random cost centers at the taxpayer’s Indiana business locations, from which to select the purchases for the sample period. The size of the sample selected was large enough to make estimates at a 90% level of confidence with a goal of 10% precision. The software also divided the sampled purchases into five strata defined by price ranges. (The Audit Summary includes a written description of the design of this sample.) The software also selected purchases from each stratum in the sample on which neither sales nor use tax had been charged, and on which the taxpayer’s self-assessment system had not accrued (and on which the taxpayer therefore had not paid) use tax (hereinafter “untaxed sampled purchases”). Within each stratum the auditor divided untaxed sampled purchases by total sampled purchases to arrive at error percentages that ranged up to 23.4613% per stratum. She also divided total untaxed sampled purchases from all strata by total sampled purchases from all strata to arrive at an average error percentage of 5.4267%. Lastly, she multiplied total expensed purchases for

each assessment period by the average error percentage to arrive at additional taxable expensed purchases.

The taxpayer retained its current representative late in the audit. This representative signed on the taxpayer's behalf separate Agreements for Projecting Audit Results (Forms AD-10A) for the expensed purchases and for the remaining tangible personal property leases. (The Audit Summary includes signed copies of both projection agreements.) By doing so the representative bound the taxpayer to accept the respective methodologies of the sample audits that had already been conducted in these categories. The expensed purchases Form AD-10A in particular incorporated the previously mentioned written description of the computer-aided design of the expensed purchases audit sample.

Viewed against these facts, it becomes apparent that the taxpayer's argument by its own terms speaks only to expensed purchases, and therefore does not and cannot apply to any portions of the proposed penalties attributable to other components of the deficiencies. Neither the taxpayer nor its representative has even mentioned the taxpayer's sales tax deficiencies or any of the other components of its use tax deficiencies, much less argued for waiver of, the parts of the negligence penalties proposed as a result.

However, even ignoring these omissions, the Department would find the taxpayer's position flawed. The taxpayer's representative signed a Form AD-10A agreeing to a sampling audit methodology for expensed purchases that incorporated the Audit Division's previous written description of the computer-aided design for generating this sample. This description in turn set out in detail the accounts and cost centers that would constitute the population from which the sample of these purchases would be drawn. The taxpayer did not object to this design at the time, nor does it now claim that the Department erred in selecting the sample derived from it or in computing any of the error percentages. Instead, the taxpayer is tacitly contending that the Department should now, after it has completed the audit, expand the sampled expensed purchases to include all expensed purchases for the sample period from all of the taxpayer's Indiana locations, as was done for the non-computer hardware leases.

The taxpayer's present argument would substantially modify the projection agreement for expensed purchases and impeach the sample audit methodology underlying it. The Department will not change agreed-upon audit methodology after the fact simply because the taxpayer does not like the result of its application. Moreover, the result of the taxpayer's proposed modification would be to lower the error percentages inaccurately and drastically. The proposed modification would have this result because the numerators of all of the error percentage ratios would still include only the original untaxed sampled purchases, not total untaxed purchases, both per stratum and overall. The Department therefore will neither agree to the modification the taxpayer has impliedly proposed nor entertain any argument premised on it, since the effect of doing so would be to impeach the Form AD-10A on expensed purchases the taxpayer signed, and its underlying sample methodology. Even if the Department were to accept the taxpayer's argument, however, as noted in summarizing this argument, the taxpayer has not submitted any documentation of the total volume of its expensed purchases for the assessed periods. The Department thus has no data it can use to make the proposed modification and test the taxpayer's

assertion, even if the Department were inclined to do so, which, for the reasons previously stated, it is not.

The taxpayer has also submitted that its adoption of its use tax self-assessment system was an exercise of ordinary business care and prudence (i.e. not negligent). It has also argued that a perfect system would have been cost prohibitive, thereby implying that the system it adopted was the most cost-effective available. The Department notes that the taxpayer has submitted no proof that a better system would have been cost prohibitive. The Department would also note that if the taxpayer's system generated errors notwithstanding its being the most cost-effective available, then the errors should have cut both ways, generating overpayments as well as underpayments, thereby prejudicing both parties equally. In other words, if a use tax self-accrual system generates any errors, one would expect it to cause remittances of use tax to the Department on non-taxable transactions, as well as to fail to remit tax on taxable ones. The taxpayer has not called any errors of the latter type to the Department's attention. Therefore, consistent with the presumption of validity of the proposed assessments mandated by IC § 6-8.1-5-1(b) (1998) and 45 IAC § 15-5-3(b)(8) (1996) (2001), the Department presumes that either no, or no substantial, errors of this type occurred during the audit period. The absence, or substantial absence, of any such errors, suggests that the taxpayer's system fell below the standard of ordinary business care and prudence, and thus was negligent.

The per-stratum error factors at which the auditor arrived, which ranged as high as over 23%, support this inference. The average error factor on which the taxpayer bases its assertion that its self-accrual system is at worst nearly 95% accurate is just that, an average. Where stratified or otherwise more detailed error factors are available, as is the case here, an average error factor standing alone is not enough information on which to make an informed evaluation of such a system's adequacy, or more accurately in this case, inadequacy. It is also necessary to consider the more detailed error factors. Having done so, the Department finds that the taxpayer's employment of a use tax self-assessment system that in some cases results in failing to accrue tax on as many as nearly one purchase transaction in four is negligent, and does not constitute reasonable cause for waiving the proposed negligence penalties.

FINDING

The taxpayer's protest is denied.